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Analysis of Finance Company Ratios in 1987

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Government statisticians call it a "break in the series". In 1988, we are presenting the 52nd Annual Survey of the Finance Company Ratios with some revisions in the ratios. Our last examination of the ratios was done in 1982 by John R. Swift, Vice President, The First National Bank of Chicago in *Ratios of the Instalment Sales Finance and Consumer Finance Companies.*

Our decision to add, revise and delete a number of ratios results from the continuing changes in the industry. There is no longer a Finance Company Industry. Instead, there are participants in the Financial Services Industry. General Motors Acceptance Corporation is the nation's largest mortgage banker; Ford Motor Credit owns one of the nation's largest Savings and Loans; and General Electric Capital Corporation is one of the world's largest owners of trains, planes and automobiles. All of these companies have their roots in retail installment credit for consumers.

The ratio changes have been prompted not only by industry developments, but also by other trends which have both positive and negative implications for the bank lender. On the positive side, the industry's overall quality has improved. This has led to higher debt ratings, and improved access to the capital markets. Unfortunately this positive factor has also resulted in a disintermediation of the banking system. Accompanying this trend has been a deterioration in the quantity of information provided to bank lenders. The Financial Accounting Standards Board's controversial rule that forces all companies to consolidate the results of all majority-owned subsidiaries could further affect the ability of the bank lender to independently judge the credit quality of his obligor.

The most frequently asked questions regarding the Finance Company ratios are answered below:

1. How is a consumer finance (direct cash lending) company defined?

   A consumer finance company is one in which the obligations of individuals represent 65% or more of assets.

2. How is a diversified finance company defined?

   A diversified finance company is one in which the obligations of corporations represent 35% or more of assets.

3. Which companies are included in the ratio analysis?

   The companies in both the consumer and diversified segments are representative of industry participants. As companies change, their inclusion in an industry segment will change. For example, Transamerica Financial's acquisision of Borg-Warner Acceptance Corporation shifts that company from a consumer to a diversified finance company. The sample size will vary from year to year due to industry consolidation and information availability.

4. How are the ratios constructed?

In general, the ratios represent the arithmetic averages of the sample companies adjusted from time to time for data availability and unusual occurrences. Volume and outstandings numbers represent the cumulative totals for the sample companies. Data sources include public reports, Robert Morris questionnaires and conversations with individual companies.

Given this background, we are continuing to review the ratios in two segments, one for consumer finance companies, and one for diversified finance companies. Within these two segments, the ratios are now arranged into five categories:

1. Assets (Portfolio Breakdown)
2. Asset Quality (Portfolio Quality)
3. Liquidity
4. Leverage/Capital Structure
5. Earnings

John Swift's book remains the standard for most ratio definitions and their interpretation. Below is a discussion of any new or revised ratios used in the 1988 analysis.

New Consumer Finance Company Ratios:

#13: *Reserve for Losses to Total Charge-Offs Net of Recoveries*
This ratio is computed by dividing the reserve for losses by total charge-offs net of recoveries. This ratio gives the analyst insight into a company's reserving policy.

#14: *Net Charge-Offs to Liquidations*
This ratio measures charge-offs, net of recoveries, as a percentage of principal collected in the period. In a consumer finance company, liquidations are inflated by loan renewals, and therefore this number is not as reliable as ratio #15 in viewing consumer loss experience. We are including it, however, to achieve a comparison basis between consumer and diversifed companies.

#23: *Total Debt to Net Worth Plus Reserve for Loan Losses*
This ratio indicates the company's debt level in relation to net worth increased by the reserve level. It is akin to a bank's primary capital ratio. It is followed by certain rating agencies, and therefore worthy of continuing analysis.

#32: *Consolidated Net Income to Average Total Assets*
This ratio measures the return on total assets.

Revised Consumer Finance Company Ratios:

#10 & 11: *Recency and Contractual Delinquency*
We have combined the aging of accounts in both categories to a single measure at the 60 day and over level.

#12: *Reserve for Losses to Net Receivables*
This ratio has been changed from Reserve for Losses to Total Receivables (ratio #16 in the 1987 analysis) due to the new audit guide which suggests reporting net receivables and the practice of not reserving for unearned income.

#22: *Total Liabilities to Tangible Net Worth*
Although substantively the same measure as the previous ratio #3, Total Debt to Tangible Net Worth, this ratio's description has been changed. It reflects overall leverage.

#35: *Times Interest Earned*
Historically we computed prior ratio #41, Times Fixed Charges Earned, in accordance with the definition prescribed by New York Insurance Law. Ratio #35 is substantially the same, but is easier to calculate directly from the income statement by dividing net income before interest and taxes by interest expense.

New Diversified Finance Company Ratios:

#9: *Consumer Losses (Charge-offs net of recoveries) to Consumer Receivables Liquidated*
See explanation in the Consumer Finance Company section.

#12: *Reserve for Losses to Total Charge-offs Net of Recoveries*
See explanation in the Consumer Finance Company section.

#13: *Net Charge-offs to Average Net Receivables*
This ratio has always been used in the Consumer Finance analysis, and is useful in determining the relative level of charge-offs and the trend over time.

#22: *Total Debt to Net Worth Plus Reserve for Loan Losses*
See explanation in the Consumer Finance Company section.

#31: *Consolidated Net Income to Average Total Assets*
See explanation in the Consumer Finance Company section.

Revised Diversified Finance Company Ratios:

#4, 5 & 6: *Percentage of Receivables to Total Receivables*
We have combined the asset breakdown into three categories: retail (end user financing), consumer and commercial (secured loans, asset based loans, leases, etc.).

#11: *Reserve for Losses to Net Receivables*
See explanation in the Consumer Finance Company section.

#21: *Total Liabilities to Tangible Net Worth*
See explanation in the Consumer Finance Company section.

#34: *Times Interest Earned*
See explanation in the Consumer Finance Company section.

Deleted Finance Ratios

Most of the ratios deleted relate to asset composition or detailed aging of delinquency. These items have not lost their significance for an in-depth look at an individual company but have been deleted due to less detailed information reporting by many companies. Cash as a percentage of Total Non-Subordinated Debt (prior ratio #1 and a measure of cash needed for compensating balance requirements) and Bank Borrowings to Total Non-Subordinated Debt (prior ratio #16) have, unfortunately, become insignificant.

In the accompanying charts we have portrayed the Consumer and Diversified Ratios for 1987. The following commentary represents our interpretation of the survey results. We have not restated prior years and our remarks are geared to the highlights.

Consumer Finance (Direct Cash Lending) Companies

Earnings

Overall, 1987 represented another excellent year for the industry. However, the various components of the earnings equation exhibited some fluctations. Lower yields (ratio #26), slightly higher operating expenses (ratio #28) and continued high loss provisions (ratio #29) were offset by lower debt costs (ratio #27) to produce a slight but not significant decline in profitability. Interest coverage (ratio #35) remained at very strong levels when viewed from a historic perspective. While our survey indicates that volume declined, this is an aberration resulting from several major companies not providing volume figures for 1987. A company by company review shows good growth, and this principally accounts for the continued strong performance.

Portfolio Quality

Net Charge-offs to Average Net Receivables (ratio #15) displayed an ongoing negative trend and recoveries on charged-off loans (ratio #16) continued to decline. However, there appeared to be some improvement in delinquencies on both a recency and contractual basis. While these results appeared to be somewhat in conflict, a possible explanation lies in the fact that the post-October 19th economy is experiencing sufficient growth to create a positive turn in credit quality.

Leverage

While economic conditions continue to be uncertain, there is little doubt that total leverage continues to inch upward (ratio #22). It is interesting to note that our new ratio (ratio #23) shows that leverage, when viewed on this basis, is substantially lower. This would argue for a continuation of the present upward trend in the more traditional measures.

Diversified Finance Companies

Earnings

Revenue declined due to lower interest rates and, what we perceive as increased competition (ratio #25), but was partially offset by lower interest expenses (ratio #26). Emphasis on continued reduction of operating costs (ratio #27) combined with a lower provision for losses (ratio #28), apparently in anticipation of lower charge-offs resulting from lower delinquency ratios (ratios #7 and #8), helped to maintain profitability per dollar of receivable at recent historical levels (ratio #29).

Portfolio Quality

Delinquencies improved in the commercial (ratio #7) as well as the consumer (ratio #8) segment of the subject companies' portfolios. This is primarily a result of an economic upturn for manufacturing companies and higher prices of imports. Consumer delinquencies have responded to a tightening of credit standards as well as to the indirect benefits of improvements in the manufacturing sector.

Leverage

Leverage continues its upward trend, as companies with high quality portfolios are able to maintain ready access to the public markets despite the increase in financial risk. Subordinated debt (ratio #23) continues to be an increasingly less important financing vehicle.

Conclusion

Whether you look at the industry by our prior or revised ratios, it continued to perform at near record levels in 1987. We remain convinced that tracking this industry via ratio analysis is a valid analytical methodology; but, to repeat John Swift's comments in his last ratio revision. "statistics of this nature . . . become meaningful only in the light of . . . thoughtful evaluation" and "individual company policies (and) the quality of management are important factors in the exercise of sound judgment with respect to the operations of a specific company". As usual, your comments and questions are always welcome. Barbara Dierolf, Vice President, Jane Julseth, Vice President, and Stephanie Spence along with numerous other associates in our Corporate Financial Services Division made significant contributions to this effort.

Consumer Finance (Direct Cash Lending) Company Ratios

Statement Date		*12-31 1987*	*12-31 1988*	*12-31 1989*	*12-31 1990*	*12-31 1991*
Assets						
Volume for Period (Millions)	1	10,270				
Total Outstanding (Millions)	2	28,767				
Average Net Receivables (Millions)	3	1,996				
% Direct Cash Loans (Real Estate Collateral) to Total Receivables	4	38.19				
% Direct Cash Loans (Unsecured or Collateral Other Than Real Estate) to Total Receivables	5	51.85				
% Retail Contracts to Total Receivables	6	12.75				
Average Amount of Individual Loan Balances	7	2,592				
% Loans to Present Borrowers	8	57.23				
% Loans Written for Longer Than 60 Months	9	14.07				
Asset Quality						
Past Due and Delinquent Accounts (Recency Basis) % Total Recency Delinquency	10	2.80				
% Total Contractual Delinquency	11	3.77				
% Reserve for Losses to Net Receivables	12	3.10				
Ratio – Reserve for Losses to Total Charge-Offs Net of Recoveries	13	1.49				
% Net Charge-Offs to Liquidations	14	3.21				
% Net Charge-Offs to Average Net Receivables	15	2.22				
% Recoveries on Loans Charged-Off	16	15.90				

Consumer Finance (Direct Cash Lending) Company Ratios

Statement Date		*12-31 1987*	*12-31 1988*	*12-31 1989*	*12-31 1990*	*12-31 1991*
Liquidity						
% Average Monthly Cash Principal Collections to Average Net Monthly Outstandings	17	5.25				
Number of Months' Collections Required to Pay Total Non-Subordinated Debt (Net of Cash) Applying % in Ratio #17 to Fiscal Date Net Outstandings	18	16.66				
% Open Market Borrowings to Total Non-Subordinated Debt	19	29.75				
% Unused Credit Facilities to Open Market Borrowings	20	101.00				
Leverage/Capital Structure						
Ratio – Total Non-Subordinated Debt to Working Capital	21	4.72				
Ratio – Total Liabilities to Tangible Net Worth	22	6.12				
Ratio – Total Debt to Net Worth Plus Reserve for Loan Losses	23	3.90				
% Subordinated Term Debt to Capital Funds	24	28.70				
% Capital and Earned Surplus to Capital Funds	25	67.70				
Earnings						
% Gross Finance Revenue to Average Net Receivables	26	26.06				
% Interest Expense to Average Net Receivables	27	7.87				
% Operating Expenses (Excluding Loss Provision) to Average Net Receivables	28	8.81				
% Loss Provision to Average Net Receivables	29	2.57				
% Net Finance Profit to Average Net Receivables	30	3.40				
% Consolidated Net Income to Average Net Worth	31	19.01				
% Consolidated Net Income to Average Total Assets	32	2.66				
% Dividends to Consolidated Net Income	33	29.56				
% Interest and Debt Expenses to Average Total Borrowings	34	9.53				
Ratio – Times Interest Earned	35	1.735				

Diversified Finance Company Ratios

Statement Date		*12-31 1987*	*12-31 1988*	*12-31 1989*	*12-31 1990*	*12-31 1991*
Assets						
Volume for Period (Millions)	1	316,400				
Total Outstandings (Millions)	2	226,400				
Average Net Receivables (Millions)	3	6,030				
% Retail Receivables to Total Receivables	4	32.0				
% Direct Consumer Loans to Total Receivables	5	32.0				
% Commercial Loans to Total Receivables	6	37.0				
Asset Quality						
% Commercial Loan Balances With Installments Delinquent 60 Days or Over (Contractual Basis) to Total Related Receivables	7	2.79				
% Consumer Loan Balances With Installments Delinquent 60 Days or Over (Contractual Basis) to Total Related Receivables	8	2.38				
% Consumer Losses (Charge-Offs Net of Recoveries) to Consumer Receivables Liquidated	9	4.24				
% Commercial Loan Losses (Charge-Offs Net of Recoveries) to Commercial Loans Liquidated	10	1.22				
% Reserve for Losses to Net Receivables	11	2.12				
Ratio – Reserve for Losses to Total Charge-Offs Net of Recoveries	12	2.25				
% Net Charge-Offs to Average Net Receivables	13	1.35				
Repossessions to Net Worth	14	4.10				

Diversified Finance Company Ratios

Statement Date		*12-31 1987*	*12-31 1988*	*12-31 1989*	*12-31 1990*	*12-31 1991*
Liquidity						
% Receivables Maturing Over 12 Months	15	60.25				
% Cash, Wholesale, Fast Turning Commercial Loans and Installment Receivables Maturing in 12 Months to Total Non-Subordinated Debt	16	45.68				
Number of Months' Collections Required to Pay Total Non-Subordinated Debt (Net of Cash, Wholesale, and Fast Turning Commercial Loans)	17	39.41				
% Commercial Paper Borrowings to Total Non-Subordinated Debt	18	46.65				
% Unused Credit Facilities to Commercial Paper Borrowings	19	82.53				
Leverage/Capital Structure						
Ratio - Total Non-Subordinated Debt to Working Capital	20	8.31				
Ratio - Total Liabilities to Tangible Net Worth	21	8.29				
Ratio - Total Debt to Net Worth Plus Reserve for Loan Losses	22	5.71				
% Subordinated Term Debt to Capital Funds	23	25.33				
% Capital and Earned Surplus to Capital Funds	24	74.68				
Earnings						
% Gross Finance Revenue to Average Net Receivables	25	14.38				
% Interest Expense to Average Net Receivables	26	6.77				
% Operating Expenses (Excluding Loss Provision) to Average Net Receivables	27	3.87				
% Loss Provision to Average Net Receivables	28	1.64				
% Net Profit From Finance Operations to Average Net Receivables	29	1.85				
% Consolidated Net Income to Average Net Worth	30	15.04				
% Consolidated Net Income to Average Total Assets	31	1.52				
% Dividends to Consolidated Net Income	32	51.88				
% Interest and Debt Expenses to Average Total Borrowings	33	7.89				
Ratio - Times Interest Earned	34	1.38				

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Material very similar to this will appear in the September 1988 issue of *The Journal of Commercial Bank Lending.*

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